City of San Diego

Pension Reform Committee

R.H. Vortmann's Minority Report

September 15, 2004

--Minority Report--

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City of San Diego

Pension Reform Commission

R.H. Vortmann's Minority Report

Table of Contents

Page No.

		Page No.
I.	Introduction	3
II.	Executive Summary	5
	A. Findings and Conclusion	5
	B. Recommendations	9
III.	Current status of SDCERS. The "Problem"!	10
IV.	How did this happen? The "root cause"!	16
V.	Recommended Solutions to Pension Deficit	21
VI.	New Benefit Plan for New Employees	28
VII.	Recommend Solutions to the Retiree Health Liability	30
VIII.	Other Issues	32
	A. 50-50 City-Employee Sharing of Pension Loss	32
	B. Disability Pension	34
	C. "Excess Earnings" and the "Waterfall" Distribution	37
	D. Role of Retirement Benefits in City's Total Compensation Pkg.	40
	E. Desired Pension Trust Funded Ratio	41
	F. DROP	41
IX.	SDCERS Governance	43
X.	Policy and Process Changes to Prevent a Reoccurrence of Current Problem	45

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I. Introduction

This report is a "minority report" addendum the Pension Reform Committee's (PRC) final report dated September 14, 2004. It is not the intent of this "minority report of one" to detract from nor supplant the PRC's report. Since I concur with much of the PRC's report and recommendations, my intent is to augment and expand upon the PRC's report, placing greater emphasis on certain issues and introducing other issues not addressed by the PRC.

The opinions and recommendations included herein are mine alone and not the PRC's. This report is derived from my experience as Vice Chairman of the PRC, as a two year Trustee of the San Diego City Employee Retirement System, as a member of Mayor Murphy's Blue Ribbon Committee on the City's Fiscal Health, as the author of that Committee's Report section on pensions, and from my many years experience with private sector defined benefit and defined contribution plans.

The nine member Pensions Reform Committee devoted significant personal time and effort over the last ten months to understand, analyze and debate the current status of the City Retirement Plan, the cause of such, and to recommend courses of action to remedy such. Given the diverse backgrounds of the PRC members, including accounting, private sector business management, legal, labor union, city retiree, and prior SDCERS experience, many different perspectives and personal philosophies were brought to the PRC's deliberation. This was precisely Mayor Murphy's intent in forming the PRC.

I believe the resultant PRC composition was very constructive and the discussion and debate brought forth by the different perspectives was enlightening and productive. While the PRC was able to reach unanimous agreement on several issues, there were other issues where unanimity was not achieved and committee positions were established by simple majority rule. Other decisions were reached by compromise as the debated issue evolved. Finally, other issues were not resolved. As with most committee efforts, the ultimate committee report and conclusions were tempered by the inherent compromise of achieving consensus across the disparate perspectives of the members.

I did not agree with the emphasis and direction of some of the conclusions in the PRC's report. Further, several points, about which I feel very strongly, did not make it into the final report. Thus, I have written the following report stating my opinion regarding the City's employee retirement program, its current condition, how the current condition evolved, and what I believe the City should do to correct the problem.

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Some of the recommendations in my report are similar if not identical with ones made by the PRC. Most are not. Where my recommendations are the same as the PRC's it is so annotated in the text for clarity. As can be seen from my report, I truly believe the problem is more severe and of a more fundamental nature than is implied in the PRC's report.

I offer this report in the hope it will add to an enlightened and comprehensive understanding and debate by the Mayor and the City Council over what needs be done to address the City's current problems with its retirement programs. Most importantly, I hope this report will help ensure that aggressive, comprehensive corrective action is taken in a timely fashion. The City's employees and taxpayers deserve that.

Respectfully submitted,

R.H. Vortmann

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II. EXECUTIVE SUMMARY

A. FINDINGS AND CONCLUSION

The intent of this report is to establish a true, factual picture of the current situation of the City's retirement plan liabilities and to make recommendations how to correct the problem. The issues are complex and a thorough understanding of such is complicated by the inherent need to deal with numbers and trends projected out 30 to 40 years through obtuse actuarial statistics and methodologies.

However, once understood, the basic issues are relatively straight forward and clear. The City has a major problem with its post retirement benefits program. The problem comprises two separate pieces: i) pension plan liabilities and ii) retiree health benefits. These two problems, while somewhat different in their origins, both represent sizeable dollar challenges for the City.

It should be pointed out as comfort to existing retirees that the Pension Trust is not in any immediate risk of insolvency. There are sufficient existing assets in the trust ($2.3 Billion as of 6/30/03, the latest available formal actuarial evaluation) to pay benefits for many years to come. (The present value of **existing** retirees' pension benefits is $1.7 Billion compared to the assets of $2.3 Billion).

Unfortunately, the same short term assurance cannot be given regarding retiree health benefits. There was only $21 million available is a SDCERS reserve account as of 6/30/03 for retiree health benefits and that will most likely deplete shortly requiring the City to fund current retiree health care costs out of the General Fund – something the City has not yet been willing to do!.

A City, not a SDCERS Problem

It must also be pointed out at the outset, the overall problem is not with San Diego City Employee Retire Systems (SDCERS). The problem is with the City and its fiscal management practices. At worst, SDCERS can be viewed as an "enabler" which allowed the City to create the problem for itself over several years. And I would submit the issue of the current composition of the SDCERS Board is the most likely explanation of how SDCERS became an "enabler".

Further, this problem was not created by the current City leadership. Rather, it is the product of actions or inactions taken by prior City leaderships going back at least eight years. It should further be recognized that the City is not unique in facing this problem. Many other local and state governments are currently living with very similar problems. San Diego County appears to be one of them.

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Investment Performance

SDCERS has performed exemplarily well in one of its most important functions – the investments of the funds entrusted to it. SDCERS investment performance over the last 10 years has repeatedly been in the top 25% of all municipalities.

The poor investment returns from the recent post bubble, stock market crash are not a principal cause of the City's current problems. Quite the contrary; in hindsight, it was most likely the excellent investment performance during the bubble market of the 90's which masked the underlying problems of the City's practices. When those unprecedented market gains were reversed with the market plunge in 2002, the problems became painfully visible.

"Bottom Line"

The bottom line issue is that the City has progressively created over time extremely "rich" and therefore very expensive post retirement benefits for its employees. The City is quick to point out that some of these benefit improvements have resulted from "lost" litigation, i.e. Corbett. However, this seems a disingenuous defense given that the City subsequently raised the benefits even further than the court settlement, all on its own accord.

Critically, the City has chosen not to pay for these benefits currently as they are earned. It appears this choice was due to economic necessity; in other words the City has promised benefits to its employees which it has not been able to afford.

As a result of several different processes, the City has effectively been deferring the cost of these promised benefits out to future year's City budgets and to future year's taxpayers. This deferral, much analogies to an individual citizen hooked on credit card debt, has created a ballooning liability due to the compounding nature of the deferral and the interest cost accumulating on that liability.

As of the most recent full actuarial evaluation (6/30/03) the Pension Plan has an unfunded liability – a deficit – of $1.16 Billion. The Pension Trust is only funded to 67% of what is should be. The Pension Trust had been funded in the low 90 percents in the 1990's, with one year (often proudly referred to) hitting 105% as a result of the stock market bubble.

The Retiree Health Benefit liability is essentially not funded at all (save for a $21 million reserve in the Pension Trust as of 6/30/03). While projecting medical costs out 30-40 years is quite problematic, SDCERS' actuary has estimated, that if the current benefits promised to retirees and existing employees are to be paid, then this liability as of today is approximately $545 to $672 million depending on whether a 5% or 6% annual medical inflation factor is used. In fact, this liability could be much larger recognizing that for the last five years medical costs have been increasing in double digit percentages.

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Pension Costs

The actuarial computed annual cost to the City to properly fund the pension plan has been steadily and dramatically rising. As measured as a percentage of payroll cost which should be paid each year, the City's required annual contribution to the pension fund has risen from 6% in 1994 to the current year's 28%, and a projection of 34% by 2009. In FY '04 the City contributed $85 million to the Pension fund (which was less than the actuarially computed required annual amount). By 2009, the required annual contribution amount is projected to be $240 million – a staggering increased requirement on the City's budget!

Retiree Health Benefits

Worse, none of the foregoing dollar amounts include anything for the Retiree Health liability. The City currently has been making **no** payments from its annual budget for Retiree Health. Rather they have been paying only existing retiree medical expenses as they come due (i.e. "pay as you go" with no recognition and accrual of the liability they are incurring every year for their existing employees' eventual medical bills when they retire).

Worse this modest payment of the current portion of the Retiree Health expense is being made not from the City's annual budget but from a deliberate, if maybe not well understood, siphoning off of pension trust assets. Thus the entire cost of retiree health benefit is being pushed out to future year's taxpayers.

Combined Pension and Retiree Health Burden on the City

What is most disturbing is the projected annual cost to the City to pay for the on-going costs of these promised retiree benefits and at the same time to pay off the accumulated "debt" from not having paid the full cost of these benefits in the past.

At the City's current rate of **partial** payment of retiree costs, in FY '05 pension costs alone will represent 13.6% of the City's total general fund as seen below.

FY '05 Budget [1]

($ in millions)

	Total Fund	Pension Contribution	Retiree Health	City "Pick-up"	Total Retiree Benefit Cost	% of Budget
General Fund	$817	$87	0	$24	$111	**13.6%**
All Other Funds (Principally Enterprise Funds)	1,196	43	0	11	54	8.2%
Total	$2,013	$130 [2]	$0	$35	$165	12.2%

[1] Data per Pat Frazier, City Manager's Office

[2] Amount dictated by the Gleason settlement

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What is staggering to contemplate is that the projection for **full** funding of both the pension and the retiree health benefit (discussed in detail later) would necessitate a dramatic increase in annual payments as follows:

Pension	$240 million [1]
Retiree Health	$ 85 million [2]
Total annual Contribution	$325 million

[1] Using FY '09 full actuarial funding rate based on 15 year amortization discussed later in this report (SDCERS actuary projection).

[2] Full actuarial funding rate based on 15 year amortization (Source: PRC computation which includes SDCERS actuary calculation of normal cost)

To illustrate the severity of the fiscal challenge to the City, and to focus on the key question of whether the City can truly afford these retiree benefit promises it has made, this full funding annual payment of $325 million (with approximately 67% or $217 million of this total allocated to the City's General Fund) would be a staggering **27%** of the total General Fund (as measured against the FY '05 budget). This would represent over one quarter of the total General Fund just for retiree benefits! And this is before any city "pickup" of the employee's share of pension cost, which is the current practice.

Very simply and critically, the City must address the basic question of whether it can afford these benefits. Can it find funding for the absolute annual dollar increase, from $130 million to $325 million? Can it afford to have one quarter of its entire General Fund spent just on retiree benefits? Is the City willing to make the hard choices to defer other spending priorities in order to be able to pay its employees the benefits they have been promised?

If the City's answer is to be "yes", then the City, for its credibility to its employees, its taxpayers and its bond holders, must demonstrate through a comprehensive long range financial forecast exactly how it intends to pay for these benefits.

If, however, as I strongly suspect, the City concludes it cannot afford these benefits, the City needs to take immediate action to prevent the problem from growing, by reducing benefits for all new employees and reducing the cost of benefits for existing employees where allowable by law. Several recommendations to address this are made below.

Summary Conclusion

To summarize, the City's problem with its post retirement benefit plans is very significant and is growing at an expanding rate. These problems need be addressed immediately and aggressively.

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It is recognized the solutions will be fiscally painful, to the City, to the employees, and to the taxpayers, but less painful the sooner the solutions are enacted. Time will only exacerbate, rather than solve, these problems.

B. RECOMMENDATIONS

I have made a series of 31 recommended actions for the City and/or SDCERS to implement to address the overall situation summarized above. The individual recommendations are stated in the body of the report, set in context of the discussion of the problem the recommendation is intended to address.

The 31 recommendations have been categorized and are discussed in the following subgroups:

1. Solution to the current Pension Deficit
2. Creation of a new, less costly retirement Benefit Plan for all new City employees
3. Solution to the Retiree Health Liabilities
4. Recommendations on various other issues:
   a. 50-50 City – Employee sharing of pension cost
   b. Disability/Pension
   c. “Excess Earnings” and the “Waterfall Distribution”
   d. Role of Retirement Benefits in City’s Total Compensation Pkg.
   e. Desired Pension Trust Funded Ratio
   f. DROP
5. Improvements in Governance in SDCERS
6. Recommendation to prevent reoccurrence of the current problems

The 31 recommendations do not all carry equal weight in that some address major issues while others address minor, underlying issues. Some of the 31 recommendations presumably will be relatively easy to implement while others will be difficult and fiscally painful.

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III. CURRENT STATUS OF SDCERS: THE PROBLEM!"

The City faces two separate, but related overall problems:

i) The cost of pensions

ii) The cost of retiree health care.

The first problem has been more discussed in the media recently but both problems are very real and very significant. The overall issue is very simple and straight forward. The City has promised its employees retirement benefits (pension and post retirement health care) at levels the City has been unwilling or, presumably, unable to pay for currently, as those benefits are earned by the employees. The City has chosen through various means to defer payments for these benefits to future years' budgets and future years' taxpayers. This deferral is compounding at an increasing rate and is placing a very inappropriate and unfair burden on the next generation of taxpayers.

The City's rationale was that while financial hardship precluded paying the full cost of these benefits currently, in the future, when times "were better," the City could not only pay the then full annual cost but also pay the catch up on all prior years' shortfalls.

The problem is analogous to an individual with a credit card. The individual buys his goods/services today and defers payment until tomorrow. Tomorrow he does the same thing. Soon the payments the individual does make are insufficient to cover even the interest on the debt. As a consequence the problem continues to balloon. What was difficult to pay back at the outset has become order of magnitude more difficult, if not impossible, to pay in the future.

The overall problem, simply stated is how will the City be able to pay for the post retirement benefits it has promised its employees. The City has not been paying the full cost of such currently for several years now, and the resulting growing "debt" clearly makes the problem far more onerous in the future.

A. UNDER FUNDED PENSION PLAN

A critical question which has been subject to much public debate is what exactly is the financial condition of the San Diego Pension System?

The quantification of the Pension System's financial status can lead to a variety of numbers, and therefore some confusion, since the estimation of liabilities that will have to be paid out over 40-50 years necessitate several assumptions for long periods out into the future (e.g. mortality averages, wage increases, inflation, investment earnings etc.). Change an assumption and you get a different answer. While the answers will differ, all scenarios indicate that he City has a significant financial shortfall in its Pension System.

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The most recent formal actuarial valuation report as of June 30, 2003, showed the following financial condition of the Pension Plan.

As of June 30, 2003	Assets at Market Value	Assets at "Smoothed" Value
Total Actuarial liabilities	$3.53 Billion	$3.53 Billion
Assets Allocated to funding	2.34 Billion	2.37 Billion
Unfunded Actuarial Accrued Liability	($1.19 Billion)	($1.16 Billion)

(**Note:** This unfunded liability, i.e. the deficit, would be even **larger** if all the "contingent" liabilities of the system were properly included. This is discussed further below.)

Recognizing that asset values fluctuate, sometimes widely, over short periods of time due to investment performance, actuaries often use "smoothing" valuation techniques to smooth out such valuating for annual measurement purposes. Thus, whether measured at market value of assets or at an actuarially "smoothed" value of assets, there is a deficit of between $1.16 Billion to $1.19 Billion. This deficit means the Pension Trust is only some 67% funded.

Funding to cover the Pension Plan liabilities comes from two sources: i) annual cash contributions from the City and ii) investment earnings on the assets held by the Pension Trust.

The City currently makes annual cash payments to SDCERS. The most recent amount, as agreed to in Manager's Proposal II, was $74.4 million in FY '04. The City actually paid $85 million (the additional $11 million coming from the Enterprise funds). This equaled 15% of payroll. Manager's Proposal II (enacted in FY '02) like its predecessor Manager's Proposal I (enacted in 1997) allows the City to contribute a formula driven annual dollar amount which is less than the actuarial determined contribution amount required for "full funding." If the City had paid the full amount due in FY '04 it would have been $117.1 million or 21.1% of payroll. Thus, the actual funding was $32 million **short** in FY '04.

With the recently agreed to tentative settlement of the Gleason litigation, by 2008, the City will have to make an annual payment of $177.5 million or 25.9% of payroll, almost two and half times more than current amount. While this $177.5 million amount is being characterized in the Gleason Settlement as "Full actuarial funding," I would submit this is somewhat disingenuous. It is only "true" given that a critical assumption was explicitly changed. The amortization period for the unfunded liability was extended from the existing 18 years to 30 years. This is analogous to extending the length of your home mortgage. When you do such, your required monthly payments go down – i.e., it costs less to be "fully funding". But obviously you must pay at that lower annual rate for a much longer time, and with the required interest added in, the total payments are much higher. In pension fund amortization schemes, the amortization computation is made not to yield a level principal and interest payment each year (like a conventional home

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mortgage), but rather to create a level percent of payroll payment each year. Since payrolls are projected to increase annually (due to inflation and typical head count growth), a level percent of payroll cost actually yields a "negative amortization" in the early years of a 30-year amortization schedule. This reduces the amount of payments that have to be made in earlier years and pushes those dollars out to future years.

Thus the Gleason mandated funding amounts in FY '06, '07 and '08 are a "creative" full funding. The unfunded liability will continue to grow (all other variables held constant) in those years.

By 2009 when the Gleason mandates expire, full funding on a 15-year amortization schedule would require a payment of $240 million (per SDCERS actuary's projection).

Given the fact the City has no formal five or ten year financial planning process, it is extremely difficult to see how the City, when it can't afford to pay the full $117.1 million in FY '04, will be able to pay $240 million in FY '09. This uncertainty represents a major fiscal challenge for the City. It also represents a major creditability problem for the City. Can the City honestly tell its employees how it is to pay for the promises it has made to them? Can the City explain this to the taxpayers?

In the meantime it is very clear that future years' taxpayers will continue, for many years in the future, to have to pay for services of City employees of **prior** years. This is a highly inappropriate fiscal policy.

B. RETIREE HEALTH CARE

The second problem the City faces relates to retiree health care. Currently the City is not making any payments on its liability for retiree health at all! Current retirees' health bills are being paid from a special reserve within SDCERS. The funding of this reserve is a "siphoning off" of funds contributed for pension costs. This siphoning off increases the aforementioned unfunded pension liability.

This is a "pay as you go system" for current retirees, year by year, as actual medical bills are incurred. There is no recognition of the long term liability for the medical costs of these retirees in future years. Worse, the City has never recognized it is also incurring a liability every year for the existing employees' right to a health benefit when they eventually retire. This liability is totally ignored by the City, or is rationalized away with the argument that this benefit is not really vested until an employee retires and that the City can do away with this benefit if it so chooses. This argument appears disingenuous in that the existing employees are currently being told they will have health benefits in retirement.

If these retiree health benefits are in fact going to be paid (as it certainly appears the current work force believes they are entitled to), then the City has a very real liability which it must recognize. While this liability is difficult to precisely quantify due to the vagaries of predicting

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medical costs out 40-50 years, SDCERS' actuary has quantified, as a rough estimate, the liability to range from approximately $545 million to $672 million given medical cost inflation of 5-6% per year. I submit, it could in fact be much larger, given that medical costs over the last five years have been increasing in double digit percentages, not 5-6%.

This $545-672 million for retiree health care is **in addition** to the $1.16 Billion of unfunded pension liabilities. The burden to fund this retiree medical cost of prior years' employee service out of future years' City budget will be extremely challenging. If this $545-672 million medical liability is to be funded over the next 15 years, it alone would cost approximately $85 m/year (PRC calculation).

C. RICH PENSION BENEFITS

A description of the City's problem would be incomplete without pointing out that the pension and retiree health benefits promised to employees are quite rich by any measurement. Every variable in the City's deferred benefit pension plan has been tweaked through the union "meet and confer" negotiations to the high end of the scale. The most glaring examples are that employees can qualify for a full pension at age 55 (General Members) or age 50 (Safety Members). The notion that you earn a reasonable, "livable" retirement from your employer as you work through your career is seriously compromised with the notion of a career completing at age 50 to 55. This is particularly true with the increasing longevity and the recognition that people in general need/want to work longer. The normal retirement age in private industry today is 62 if not 65. Social Security retirement age has been raised to 66-67. The U.S. Pension Benefit Guarantee Corp. assumes people work until age 65 and they reduce benefits to anyone retiring earlier. Medicare also assumes people pursue their career until age 65, earning medical benefits while working until that age.

The problem with this early retirement age is significantly compounded by a very lucrative pension payout itself, 2.5% of salary times years of service (General Members) to 3.0% of salary (Safety members). This is close to twice, if not more, the norm for the private sector. As an example, an individual (General Member) starting work at age 22 can retire at age 55 with a pension equal to 83% of his/her highest salary for the rest of his/her life – statistically almost as many years as he/she worked. A Safety Member starting at age 22 can retire at age 50 with a pension equal to 84% of his/her highest salary for the remainder of his/her life – and as measured from age 50, the individual will on average receive pension payments for **more** years than he/she actually worked. And these pensions also escalate over time with a COLA such that the exampled retiree will be making **more** money in retirement than they earned when working.

Other examples of the "richness" of the plan are:

i) Salary is defined to be employee's **single** highest year salary versus the **average** of either the three or five highest year's salary found in most private sector plans,
ii) A very liberal criteria for disability pension

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iii) A “13th check” (contingent on certain events)
iv) A supplemental COLA (contingent on certain events)
v) A DROP program wherein the individual can continue working at full salary on benefits for up to 5 years, while **at the same time** receiving his/her pension (a problem exacerbated by the very early retirement age).
vi) Ability to purchase service year credits to add to their pension.

Simply stated, a very rich pension is being earned over a relatively short working career. Consequently, the cost of such pension to the City on a per year worked basis is quite high.

D. CITY’S “PICK-UP” OF EMPLOYEE’S SHARE

The basic pension plan was originally designed by City Charter to be paid for 50% by the City and 50% by the employee. However, any “past service liability” is by City Charter to be paid 100% by the City. Worse, as the City has continued to richen up the pension plan and the cost of such has risen for the employee, the City has agreed to “pick-up” an increasing portion of the employee’s 50%. Currently because of this “pick-up” the City is obligated to pay approximately 88% (General Members) and 91% (Safety Members) of the total pension “normal cost” plus 100% of all costs deemed to be “past service liability,” rather than just the City’s 50% in the basic 50-50 City-Employee sharing concept.

E. EMPLOYEES DO NOT GET SOCIAL SECURITY

It is often said that the reason City pensions are so “rich” is that City employees do not participate in Social Security. That is true. As such the employee saves the 6.2% FICA tax payroll deduction and the City saves the corresponding employer’s 6.2% payroll tax. However, as an offset to the absence of a Social Security benefit, the City has granted General Member employees a SPSP plan (but not Safety Members, who enjoy a bigger pension factor than General Members, 3.0% v. 2.5%). The SPSP is a defined contribution pension plan which is in **addition** to the basic pension (the defined benefit plan). The City pays 3.05% of the employee’s salary into this SPSP plan. The employee must contribute 3.05% as well and can voluntarily contribute up to another 3% which the City will match. Thus the City has to contribute up to 6.05% of the employee’s salary – an amount essentially equal to the Social Security tax the City does not have to pay. So in essence, the City employee gets the same employer paid benefits through SPSP that he otherwise would get in Social Security, although it is a defined contribution rather than Social Security’s defined benefit. A further note on Social Security, a City employee retiring at 50 and 55 would not receive much from Social Security participation when they reach age 65 since Social Security assumes you work and pay Social Security tax until age 62 or 65. The City’s SPSP plan, being a defined contribution plan, has no such age based reduction.

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F. CONCLUDING OBSERVATION

This overall retirement cost problem facing the City, both pension and retiree health, was well articulated in the Mayor's Blue Ribbon Finance Committee report of February '02 (albeit significantly under stated based on the incomplete understanding by the Blue Ribbon Committee at that time). The Blue Ribbon Committee recommended that the City grant no further retirement benefits until the City fully comprehended the problem they already faced and devised a corrective plan of action. Unfortunately the City did not heed this advice and instead granted further pension benefit improvements and orchestrated, via Manager's Proposal II, a further deferral of costs out to future year's taxpayers.

The City of San Diego is not alone in regards to employee retirement program problems. Many other municipalities and state governments currently face similar problems, with many of the same basic causes for such. Close to home, San Diego County has faced a similar pension under funding problem caused by an extremely rich benefit plan. That problem has recently been "solved," or rather "masked," by the issuance of successive, sizeable pension obligation bonds. Thus, while the San Diego County's pension trust does not show as large a percentage deficit as does San Diego City, the County has incurred significant bond indebtedness to cover past years' pension expenses; those bonds will have to be paid off by future year's taxpayers for many years to come. Thus, the County, much like the City, has pushed prior year's employee retirement costs out on to future year's taxpayers.

As further evidence of the broad ranging scope of these retirement benefit problems, Federal Reserve Bank Chairman Allen Greenspan recently admonished Congress to cut Social Security and Medicare benefits, saying "the government has promised more than it can deliver".

The private sector is also encountering significant problems with defined benefit pension plans, particularly in the old legacy smokestack industries and the airlines; witness Bethlehem Steel which defaulted on its pension plan leaving a deficit of $3.6 Billion and United Airlines' pending default with a deficit of $8.3 Billion. The Pension Benefit Guarantee Corp. is reportedly already $10 Billion short of what it needs to pay the benefits it has assumed from private company plans which have gone broke.

However, notwithstanding, the fact the other plan sponsors, both public and private sector, are suffering similar or greater problems as is San Diego, the City **must** aggressively address and solve this problem in as short a period of time as possible to minimize the burden pushed out on to future years taxpayers for past years' inappropriate fiscal practices.

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IV. <u>HOW DID THIS HAPPEN? THE "ROOT CAUSE!"</u>

A. THE PENSION PROBLEM

First and foremost it is useful to state what did **not** cause the problem. The problem is not one of SDCERS' creation; rather it is the **City's** problem. SDCERS is the Plan Administrator and fiduciary manager of its assets; the City is the Plan Sponsor and the financially responsible party. At worse, SDCERS can be seen as an "enabler," whose actions or inactions allowed the City to create this problem by not paying its bills currently.

Secondly, the problem is **not** the result of investment losses. Much has been said publicly on this issue recently, and again each of those answers must be taken in context of their respective questions. Recent actuarial reports have stated that the majority of the increase in unfunded liability was the result of poor investment returns. This is true when looking only at the last few year's of serious "bear" market results. However, more importantly, what is also true is that SDCERS, to its credit, over the long term has done very well with its investment performance – much better than the average municipal pension fund. SDCERS investments results have been essentially equal to its required actuarial investment earnings assumption of 8% per year.

SDCERS' investments did very, very well during the unprecedented stock market boom of the '90's and then performed less well (i.e. did not make their actuarially necessary 8% per year) after the stock market bust in 2000. However, when measured overall for the past 10 years, on average, investment performance has **not** been a principal culprit in creating the current $1.17 Billion unfunded liability. SDCERS' Actuary recently (5/18/04) stated unequivocally that his analysis shows "the existing level of unfunded liability is principally due to elements **other than investment activity**" (emphasis added).

If not investment performance, what then was the cause? The basic cause was that the City did not fund SDCERS adequately. This became acute in 1997 with the passage of "Manager's Proposal I." This is where SDCERS's culpability enters, in that they allowed this to happen instead of demanding the City pay its full fare currently. The City pleaded financial hardship and sought and received permission to defer payment until a later date. Greatly exacerbating this fatal first step, were four critical additional issues.

Pension Improvements

First, the City continued to grant further pension improvements while pleading financial hardship and inability to pay its current obligations. With annual funding fixed per Manager's Proposal I these new benefits created a further funding shortfall.

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Litigation Increased Benefits

Second, the "Corbet" litigation was settled and, in the process, benefits were improved even further (again without any increase in funding).

Actuarial Losses

Third, over time the plan incurred actuarial experience losses. These were created when actual results such as employee turnover, pay increases, service purchase subsidies, DROP computation, turned out to be more costly in actuality than they were actuarially projected to be. This also added to the funding shortfall.

Contingent Benefits

Fourth, the City granted the employees certain "contingent" benefits which were to be paid out of CERS' "excess earnings." "Excess earnings" is a complete fiction in actuarial terms. The concept assumes in years when actual investment earnings exceed the 8% actuarial earnings assumption, there is "free" money to be used for other things, rather than the obvious reality that actual earnings tend to cycle around the **average** of 8% over multiple years. If the excesses are siphoned off in good years, there is nothing available to cover the shortfall in the "bad" years (when earnings fall short of the 8% target). Corbet benefits, the 13th check, the supplemental COLA, the medical bills of current retirees, and a portion of the City's "pick-up" of the employee's 50% of pension costs were funded through this creative fiction of "excess earnings."

There is no "free" money. The siphoning off of assets leads to actuarial losses which must be made up with additional funding in future years from the City. It is another clever device for pushing current year's cost out to future year's taxpayers. SDCERS' actuary has been counseling against this concept, or at best to properly account for it, for some time now, to deaf ears (again, culpability of SDCERS). It is of interest to note that when these contingent benefits to employees are "funded" in this manner, the costs of those benefits in essence become "past service liabilities" which by law are paid 100% by the City instead of a 50-50 sharing between the City and the employee.

Past Service Liability

Another factor that causes significant increases in pension funding in general is the concept of "past service liability."

When a new, improved benefit is granted to existing employees with retroactive applicability for all prior years of service (as essentially all recent years' benefit improvements have been structured by the City), a "past service liability" is created along with an increase in the annual pension "normal cost." The normal cost is the cost of this new benefit to be earned by the employees in each of the years they work from the date of the new benefit until retirement.

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Thus that normal cost is properly paid out of the annual budget (and therefore by that year's taxpayers) in the year the City (and the taxpayer) derives the benefit of that employee's service. In contrast, the past service liability must be paid by future years' taxpayers over a specified number of years in the future (i.e. the past service liability "amortization period"). Thus those future years' city budgets (and future years' taxpayers) bear the costs of employee service which was rendered many years in the past.

Exacerbating this problem is the fact that the City Charter dictates 100% of this past service liability is to be paid by the City whereas normally the cost of the pension benefits are shared by the City and the employee 50-50. Clearly the retroactive nature of a benefit improvement for existing employees is an extremely expensive proposition for the City. Essentially all of the benefit improvements over the last 10 years have been retroactive for existing employees rather than prospective only. (There is a recommendation below to better deal with this problem in the future.)

Stock Market Performance

Coincidentally, while all this was happening in the late '90's, the stock market was booming and CERS investments were earning greater than actuarially assumed. This gave "cover" for the aforementioned shortfalls. For everyone who wanted to believe stock market booms last forever rather than cycle up and down, the City had "no problem." Then when the stock market turned down in 2000, the problems become very visible. This is when some chose to (disingenuously) say it was now all the fault of poor investment performance.

Quantification of Causes of Deficit

SDCERS' actuary recently made an analysis to quantify the component causes of the increase in the pension funding shortfall from $57 million level in 1996 to the current (FY '03) $1.16 Billion (i.e. a $1.1 Billion increase in the deficit). The study showed that investment performance was only a very minor (i.e. 7%) contributing factor over the last 7-8 years. The City's improvement in pension benefits, use of "excess earnings" for additional benefits, purposeful under funding by the City and actuarial losses were the principal causes or can be seen in the following table.

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Causes of Deficit
($ in millions)

Benefit Improvements-Past Service:		
General	$225	21%
Corbett	242	22%
Sub-total Benefit Improvements Past Service	**$467**	**43%**
Use of Reserves for Additional Benefits		
General [1]	$187	17%
Corbett	35	3%
Sub-total Use of Reserves for additional Benefits	**$222**	**20%**
City's Under Funding (MP I 7 MP II)	$186	17%
Assumption changes & non asset experience	104	9%
Asset Investment Performance	78	7%
Service Purchase Liability Loss	40	4%
Total	**$1096**	**100%**

[1] Includes excludable reserves of $81 million or 7%

(**Note**: The above table reflects a revised analysis from what was included in the PRC report. This analysis, which was confirmed with only minor differences by an independent audit performed by Mercer Human Resources Consulting for SDCERS, became available after the PRC report went to press. It does not alter any of the PRC report's conclusion. A precise allocation of dollars by cause is complicated by the interdependency of these issues.)

B. RETIREE HEALTH BENEFITS

Retiree Health is a separate and distinct problem from the Pension Trust deficit. The cause of the retiree health problem is simple and straight forward. The City has very simply just chosen not to recognize that they are incurring an expense every year they promise existing employees a health benefit upon retirement. Sadly, there are no government accounting rules which require the disclosure of this liability (although this is about to change), and the City chooses not to recognize it.

Private sector accounting rules changed back in 1990 and began requiring disclosure of retiree health cost liabilities. As a result of no longer being able to "hide" from this latent liability, many private sector companies in recognizing this liability at that point, realized they could not afford what they had offered. Many cancelled their program for existing retirees and/or existing employees. Many of these companies lost in the ensuing litigation and had to reinstate and pay for the benefits. Most companies did successfully eliminate or sharply curtailed the benefits prospectively for existing employees and for new employees.

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The complete absence of any recognition of this growing liability for the future retirement health care of existing employees has now created a $545-672 million problem (assuming those benefits are not cancelable by the City to avoid this liability). This bill must be paid. Future years' taxpayers are already on the hook for the City's negligence of past years. The longer it takes the City to address this very formidable fiscal challenge, the longer **future** years' taxpayers will be paying for **prior** years' City services.

C. CONCLUSION

To summarize, the cause of the City's problem is quite simple. Once you blow away all the smoke, best case, the City **chose** not to pay its retiree liabilities currently in favor of other funding priorities; worst case, the City was **not able** to pay for its retiree liabilities. If the latter is true, as I suspect, the problem is severe indeed, as the liabilities not paid to date have grown significantly, with interest thereon (and continue to grow at an escalating rate), such that payment tomorrow will be much more challenging than what proved impossible to do the last few years.

Future years' taxpayers are already "in debt" for past years' City expenses. The longer it takes the City to stop perpetuating this highly inappropriate fiscal behavior, and the longer it takes to correct this very serious problem of the past, the longer the future generation of taxpayers will be burdened with the fiscal mistakes of the past.

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V. RECOMMENDED SOLUTION TO PENSION DEFICIT

A. ALTERNATIVES INVESTIGATED

The PRC investigated a variety of approaches to increase the amount of money in the Pension Trust. Consideration was given to what other public agencies who faced similar problems have done. San Diego County's repeated use of Pension Obligation Bonds is but one example.

The principal alternatives which the PRC investigated and considered are the following:

- Optimistically "hope" for an investment market boom to make up the shortfall.
- Reduce the level of benefits for current employees and then reduce there by future cost to the City.
- Change the actuarial assumption to make the deficit appear smaller.
- Encourage early retirements.
- Call for a general tax increase to specifically fund the deficit.
- Seek additional cash contributions from the City.
- Seek additional cash contribution from the employees.
- Pension obligation bonds.
- City contributes real estate to the Pension trust.

B. OPTIMISTIC "HOPE" FOR INVESTMENT MARKET BOOM

The stock market losses or poor investment performance was not a principal cause of the current problem. Therefore "hope" for above average investment performance in the future is not a viable or acceptable corrective strategy.

C. REDUCE THE LEVEL OF BENEFITS FOR CURRENT RETIREES AND/OR EMPLOYEES

It was concluded from legal advice received this was not legally possible. Existing retirees have a clear vested right to their current benefits. For current employees, unlike in the private sector

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where pension benefits can be curtailed or modified prospectively (but not retroactively), by State law a public employee is essentially guaranteed to receive at his/her eventual retirement date the level of benefits he/she was promised on his/her **date of hire**.

Thus this potential solution is not legally available. It is possible to "close" the existing pension plan to new, yet to be hired employees and offer the new employees a less expensive plan. This alternative will not reduce the current pension deficit but would, by lowering the City's future cost for pensions, make funding the current deficit easier. This alternative is discussed more fully in Section VI below.

D. CHANGE THE ACTUARIAL ASSUMPTIONS

It is well understood that an actuarial computation of pension liability out 40 years is dependent upon many actuarial assumptions. Change any of those assumptions and you change the present value of the pension liability, and thus the deficit.

However, the current actuarial assumptions are reasonable and therefore it would be disingenuous to alter those to create the illusion of a smaller pension deficit. But while the current actuarial assumptions are reasonable, SDCERS should convert its actuarial **method** back to the Entry Age Normal (EAN) method from the current Planning Unit Credit (PUC) method. EAN method is clearly the more widely used method by municipalities. It tends to call for higher funding in earlier years of an employee's tenure. The City and SDCERS' switched from using the EAN to the PUC in the mid '90's.

E. ENCOURAGE EARLY RETIREMENT

This is not left to be an effective nor appropriate solution.

F. CALL FOR A GENERAL TAX INCREASE

The PRC concluded it was not in their purview to call for general tax increases to fund the pension plan. This was believed to be the purview of the City Council or, in most cases, the purview of the City voters who would have to vote on such a tax increase.

G. SEEK ADDITIONAL CASH CONTRIBUTION FROM THE CITY

Obtaining additional monies from the City is critical and is central to any solution. The City has to get its annual cash contribution up to the full actuarial computed funding rate as soon as possible. The recent pending settlement of the Gleason litigation requires the City to contribute at the "full rate" starting in FY '05, however that resulting dollar amount was effectively reduced by the pending settlement allowing a change in actuarial assumption – the past service liability amortization period being extended from 18 years to 30 years.

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It was a surprise to learn that the use of amortization periods of greater than 18 years that are designed to create annual payments as a constant percentage of City payroll, actually creates a "negative amortization" in the first several years of that formula. This means that a "negative" principal payment is made. Instead of paying both interest and some principal each year as a homeowner does with a conventional level payment mortgage, the City would pay full interest **minus** the negative principal "payments."

As a consequence, it is recommended below that in the future (after the Gleason legal settlement time table) that no amortization period longer than 15 years should be used.

H. SEEK ADDITIONAL CASH CONTRIBUTIONS FROM EMPLOYEES

This is not felt to be a viable alternative. However a closely related issue is addressed below under the section 50-50 City – Employee sharing of Pension cost.

I. PENSION OBLIGATION BOARDS (PBO's)

The PRC discussed these alternatives at great length. It was recognized that, assuming the City has adequate bonding capacity and can borrow at interest rates below The Pension Trust earnings assumption (currently 8%), then there is the potential benefit of interest arbitrage – i.e. borrow at 6% and invest at 8%. There is also the benefit of "maturity arbitrage" in that PBO's can be written for some 30 years. The cash provided by the PBO will be contributed to the Pension Trust to eliminate (or reduce) the deficit. The City will pay off the PBO's, principal and interest, over 30 years, whereas otherwise the Pension unfunded liability would have had to be paid off in the current 18 year amortization period (or the below recommended 15 years).

Further it is felt there is great benefit of converting the current pension deficit which could be viewed as a "soft liability" or "off balance sheet debt" (the payment of which could be delayed or manipulated through devices such as Managers Proposal I and II) into a "hard debt" (a specific third party lender liability on the City's books). This "hard liability" is clearly and unambiguously disclosed, and it **must** be paid annually – there is no potential for "deals" to delay payments to some later date.

It was also recognized that the use of PBO would inject the largest amount of money in the quickest time frame into the Pension Trust. It was felt that, importantly, this would allay the growing and disturbing fears of retirees and employees that they might not get their pension.

J. CITY CONTRIBUTES REAL ESTATE

It was recognized that there might be limits on the City's debt capacity or other pressing City needs for that capacity thus making the PBO means of injecting cash into the Pension fund problematic. An alternative is for the City to sell City owned real estate and to contribute the

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cash proceeds or to contribute the actual real estate in kind to the Pension Trust. This could be a means of significantly reducing the Pension deficit without a "cash cost" to the City.

K. CONCLUSION

A sizeable infusion of assets into the Trust phased in over three years as a partial "catch-up" is imperative. Additionally the City has to fund to the full actuarial funding rate each year starting in FY '06 (using the liberal 30 years amortization period specified in the Gleason Settlement) and by FY '09 to switch to the more prudent 15 year amortization period (which will require larger annual dollar funding contributions than the "temporary" 30 year amortization period).

Recommendation # 1: *(Identical to PRC's Recommendation)*

The City is to inject a special $600 million infusion of assets into the trust over three years as follows:

The City to issue $200 million POB by 12/31/04.

The City to inject a second $200 million into the Fund by 12/31/05 from either a POB or real estate (the sale of City owned real estate with the cash contributed to the Trust, or the real estate itself contributed to the Trust).

The City to inject a third $200 million into the Fund by 12/31/06 from either a POB or real estate.

The City to contribute annually at the full actuarial funding rate starting in FY '05, FY '06, '07, and '08 based on 30 year amortization (the "Gleason Settlement"), and in FY '09 and thereafter based on a 15 year amortization (whether "fixed" or "rolling" is left to SDCERS to decide). These required full funding annual contributions are to be computed with full recognition of the increase in Plan assets resulting from this aggregate $600 million injection of funds.

This should reduce the current funding deficit by well more than half by FY '09. It will however significantly increase the annual cost of the City as follows:

Approximate annual City cash cost (to fund the Pension Trust and to pay off the PBO's) would be as follows:

FY '05	*$130 million **
FY '06	*$163 million **
FY '07	*$175 million **
FY '08	*$210 million **
FY '09	*$216 million **

**set by litigation settlement*

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This will be a significant fiscal challenge for the City but it is a critical first step. The result of these recommendations is that the current 67% funded ratio of the Pension will improve to approximately 89%. Obviously despite this very significant increase in annual City expense, the pension fund will still be well below 100% funded.

Recommendation # 2:

Create a City Charter requirement for SDCERS to utilize an amortization period no greater than 15 years for actuarial losses and no shorter than five years for actuarial gains, starting in FY '09 after the Gleason Settlement provision terminates.

SDCERS should switch from the current PUC (Planned Unit Credit) actuarial method to the EAN (Entry Age Normal) in FY '09.

L. CONTINGENT LIABILITIES

In addition to the current $1.16 Billion deficit, there are also a series of "contingent" benefits which are not included in the actuarially computed deficit. These include the 13th check, the Corbet settlement, the supplemental COLA.

Since their payment is contingent upon the availability of "excess earnings," SDCERS has decided not to include them in the computed liability. When they are actually paid out in any given year, that payment creates an actuarial loss and as such adds, a year at a time, to the unfunded liability.

This is not a prudent manner to account for these benefits. Since the City has granted these benefits they should be fully recognized (given due deference to their contingent nature where appropriate) and included in the actuarial computation. By doing such would increase the Pension deficit but it would make this very real, albeit contingent, liability fully visible and well understood.

Recommendation # 3:

Instruct SDCERS to include all contingent liabilities in the actuarial computation of total pension liabilities and in the actuarially computed annual funding rate.

If this recommendation is not accepted, then it is imperative to reduce the actuarial earnings assumption to otherwise account for the actuarial drain caused by these contingent benefits. However, care must be taken in doing this so as not to unintentionally enhance the value of these contingent benefits through the mechanics of the "excess earnings waterfall" discussed later below.

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M. ADMINISTRATIVE EXPENSES INCLUDED IN ACTUARIAL CALCULATION

Currently SDCERS administrative budget is not considered as a cost in the actuarial assumptions to determine the City's funding requirements. Thus the City is not paying this cost currently. This annual budget is approximately $20 million, the largest component of which is investment managers' fees.

The payment of this budget annually by SDCERS creates actuarial losses which adds to the Pension deficit. Thus the City, instead of paying this cost currently, on an annual basis is spreading this cost out of many years in the future.

Recommendation #4:

SDCERS's annual operating budget be included in the actuarial computation of annual funding requirements such that the City pays this cost currently and no longer pushes it out to future year's taxpayers.

N. CITY "PICK-UP" OF A PORTION OF EMPLOYEE'S SHARE OF PENSION COST

Costly to City

One aspect that makes the existing pension plan even more expensive for the City is the "Pick-up" concept. The original premise of the pension plan was that the cost of the normal pension was to be shared 50-50 between the City and the employees. Over the years as the City has improved the level of pension benefits and the cost of the pension has risen accordingly, the City, through Meet and Confer union negotiations, has agreed to "pick-up" or pay on behalf of the employee, a portion of the employee's 50%. This has become so pronounced that now the City is paying 76% of the General Member's 50% and 78% of the Safety Member's 50%. Thus given the City's 50% plus the City's pick-up of this large part of the employee's share, the City is now paying approximately 88% (General Members) and 91% (Safety Members) of the "normal cost" of the pension rather than 50%.

City is pushing this cost out on to future year's taxpayers.

Worse, part of the City's pick-up for current year employee's expense is being paid, not out of the current year city budget, but rather through the accounting fiction of "excess earnings" in the SDCERS Trust. By so doing, the City spreads the actual cash cost to the City for the current year's expense out some 18 years through SDCERS' amortization of actuarial losses. It is unclear to me on whose authority this was done, the City's or SDCERS.

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Opportunity for immediate City cost reductions

While the extremely rich levels of benefits in the pension plan cannot by law be reduced for current employees, this "pick-up" is one area where the City can make reductions in an effort to get the total cost of this pension plan back down to affordable levels. Such a step will be in essence an income reduction to the City employees. However, it must be recognized the "hurt" in reforming this unaffordable pension plan must be shared by all, including those who benefit from the rich plan.

Recommendation #5:

The City should (through Meet and Confer if necessary) phase out the "pick-up" of employee contributions over the next three years. The three year phase out is to cushion the economic pain (in essence a "wage" cut of some 2.7% - 3.3% per year for each of the three years) to the employees. The City must commit to utilize this budget "savings" to help fund the necessary increases in annual contributions for both pension and retiree health recommended elsewhere in this report to ensure the employees will, in fact, receive their promised benefits in the future..

Recommendation #6:

As an alternative to reducing the City's pick-up of a sizeable portion of the Employee's 50-50 share of the pension cost, if this is felt too severe a reduction in the employee's effective take home pay, the City should then investigate the legality of negotiating a reduction in the current "unaffordable" pension plan and retiree health benefits in lieu of reductions in the City's pick-up.

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VI. <u>NEW BENEFIT PLAN FOR NEW EMPLOYEES</u>

The City has to come to grips with whether or not it truly can afford the current levels of retirement benefits it has promised its employees.

As mentioned above, it is recognized that by California Law, the benefits for existing retirees and existing employees cannot be reduced or eliminated. Thus the City must find the fiscal wherewithal to, at a minimum, continue to pay those benefits to the entire existing workforce. However costs in the future could be reduced down to more affordable levels by "closing" the current pension plan to any new participants and creating a new plan for all yet to be hired new employees.

It is recognized that by doing such the City would be creating two "class of citizens" in the workforce with different benefits despite the employees working side by side in the same job. However, the fact that the existing plan has proven (de facto) to be unaffordable by the City necessitates this action.

<u>Recommendation #7:</u> *(Identical to PRC's Recommendation)*

Considering the richness of the annual plan and the City's unwillingness or inability to currently pay for that plan, the existing plan should be closed immediately to all new employees.

<u>Recommendation #8:</u>

A new, much less expensive plan must be created for all new employees. The value of the new benefits should be reconciled with prevailing practice in private industry and not compared to municipal or state plans, as the latter have tended, over time, to match one another to the highest common denominator.

The City must chose between a new defined contribution plan (DC), which leaves no residual liability to the City, or a new defined benefit (DB) plan of the same character as the current plan but with much less rich terms.

Given the fact that the initial annual cost to the City for both a DC and a DB plan can be set essentially equal through the establishment of the specific benefit terms of each plan, the criteria for choosing which type plan will be more philosophical rather than cost driven. Issues such as classic employer paternalism wherein the employer retains responsibility for retirement fund investment (and investment market liability or benefit from such responsibility), versus giving that responsibility directly to the employee. The DC plan tends to offer more portability which has value to many employees who tend to

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change jobs whereas the DB plan, at least in theory, tends to encourage longevity of employment with a single employer.

The choice between a DC and a DB involves many issues and the City's Human Resources Dept. need assess such carefully.

However, in the event the new plan is determined to be a defined benefit plan like the existing one, then the recommended key changes from the existing plan, to place the value of the pension plan in closure conformity to the norms of the private sector, are as follows:

1. *Increase the age for normal retirement to:*

General Members	*62*	*(from 55)*
Fire & Safety	*57*	*(from 50)*
Legislative	*62*	*(from 55)*

2. *Reduce the full retirement percentage payout factors for Retirement Benefits to no greater than (**and ideally less than**):*

General Members	*2.0%*	*(from 2.5%)*
Fire & Safety	*2.4%*	*(from 3.0%)*
Legislative	*2.8%*	*(from 3.0%)*

3. *Increase in the minimum age to elect a reduced, early retirement to:*

General Members	*55*
Fire & Safety	*52*
Legislative	*55*

   Benefits for an early retirement will be actuarially reduced on a cost neutral basis.

4. *Change from the highest year's salary to the average of highest three year's salary.*

5. *Eliminate the DROP and purchase of years of service credit provision for all New Employees of the City, except where required by California or Federal Law.*

6. *Strengthen the criteria for disability (see discussion of disability pensions below).*

7. *Eliminate the COLA in the pension plan.*

8. *Eliminate participation in the 13th check and the supplemental COLA.*

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VII. <u>RECOMMENDED SOLUTIONS TO RETIREE HEALTH LIABILITIES</u>

The City has a very serious problem with its promised retiree health care benefit. It is well recognized that medical costs have been and continue to skyrocket. Also, we have an aging population with longevity continuing to increase. Thus any retiree health care benefits are a very expensive proposition to begin with. The City's current "pay as you go" system ignores the accumulating liability being incurred each year as current employees earn their right to retiree health care. While this right to health care will not manifest itself in cash expenditures until the employee retires, the expense is being incurred now, each year the employee works. This is completely analogous to the pension benefit – i.e. paid at retirement but earned and expensed each year the employee works. While the City sets aside monies each year for these ultimate pension benefits, it does not set aside **<u>any</u>** money for the retiree health. This has led to a totally unfunded liability estimated by SDCERS actuary to be between $545 and 672 million depending on medical cost inflation assumption (5-6% per year). I believe the liability is much greater than that given the history of medical cost increases being far in excess of 5-6% per year.

It is recognized that most other municipalities follow this same practice as the City of not funding this liability. Additionally many private sector companies also do not fund their future retiree medical liability. However, private sector accounting rules (FASB) require this medical liability to be clearly shown on the Company's balance sheet.

<u>CONCLUSION</u>

The City's policy of not recognizing its retiree health care liabilities must be changed. For the City to render an accurate, clear picture of its financial condition, this liability must be disclosed. Additionally, the current practice of funding only on a pay as you go basis must be changed, particularly when it is recognized that even this very limited pay as you go funding is not being paid out of the City budget each year but rather is being paid by an inappropriate siphoning off of pension assets (via "excess earnings"). The City must stop pushing this liability out on to future year's taxpayers.

Further the City cannot have it both ways – i.e. telling employees they are earning a retiree health benefit and at the same time saying they do not have to fund the cost of such a benefit since it is "not vested" and therefore the City does not necessarily have to pay it if it chooses not to. Cleary, this is not fair to the City's employees. The City acknowledges the existing retirees do have a vested benefit to medical care but that existing employees do not.

These necessary corrections to current City practices will require significant monies out of the annual City budget. However that is a fiscal reality. It exists today but it is well hidden and simply being deferred out to future year's taxpayers. If the City concludes it cannot afford this cost, it must decide whether it wants to continue this employee benefit.

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<u>Recommendation #9</u>:

The City must definitely conclude whether the current employees have a vested right to retiree health care. If the answer is no, the employees should be honestly told so. If the answer is yes, the liability for such needs be recognized and funded.

<u>Recommendation #10</u>:

*Immediately stop funding retiree health care through the current method of siphoning off pension assets though the fiction of "excess earnings." Eliminates Muni Code Section 24.1502(a)(5) which specifies this current treatment. Commence funding annually from City budget on an actuarial basis with an amortization period no greater than 15 years. (This will be necessary for the existing retirees at a minimum since their benefit is clearly vested, and for existing employees as well **<u>if</u>** the City confirms its commitment to retiree health benefits.)*

<u>Recommendation #11</u>: *(Identical to PRC's Recommendation)*

Establish a separate trust for Retiree health care, separate and distinct from the Pension Trust.

For administrative efficiency have SDCERS manage both the Pension and the Retiree Health trust and allow SDCERS to commingle the two trust funds for investment purposes only, if they so decide.

<u>Recommendation #12:</u> *(Identical to PRC's Recommendation)*

To assure adequate disclosure and visibility on the cost and funding status of Retiree Health benefits, City should adopt GASB 43 accounting reporting requirements at the beginning of FY '05.

<u>Recommendation #13</u>:

Consistent with Recommendation #8 regarding a new, less expensive Pension plan for new employees, the City should develop a new retiree health care plan for new employees which puts a clear cap on future medical cost per employee and which is deemed affordable by the City given that it must be funded annually on an actuarial basis.

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VIII. OTHER ISSUES

During the PRC's investigation several other issues came to light and were discussed to varying degrees but were not driven to a conclusion.

A. 50-50 CITY-EMPLOYEE SHARING OF PENSION COST

The basic premise of the pension plan established in the Muni Code back in the 1930's is that the cost of a "normal pension" is to be paid 50% by the City and 50% by the employee. Any past service liability is to be paid 100% by the City. It is unclear what was meant 70 years ago by the term "normal pension". However, it is clear that this should not be confused with the current actuarial term of art, "normal cost" of a pension.

Cost of benefit improvements

When benefits are improved the actuarially computed cost of such increases are to be shared 50-50. When actuarial assumptions are changed, then the resulting change in actuarial computed costs are to be shared 50-50. This latter point was contested by San Diego employees and litigated decades ago and the City's position was confirmed up through the California Supreme Court.

Appears SDCERS not properly calculating employee rates

It is questionable whether CERS has been administering the plan according to the above stated rules. It is unclear whether the cost of every benefit increase was in fact shared 50-50, and, if it was, whether the employee rates were adjusted timely. There were some benefit increases that were granted in the time period when Manager's Proposal I had "frozen" the City's contribution rate with the City's deficiency to be made up later. But it is unclear whether future make up of the employee's required increased rates was comprehended. Benefits were also increased as a result of litigation. It is unclear whether the employee rates were appropriately increased for such.

It is apparent that when some (or all) of the recent actuarial assumptions changes were made (or were frozen by MP-I, to be "paid for" by the City later), the employee rates were not increased.

The consequence of the foregoing is that it appears the City is paying more than its 50% share in conflict with the basic premise of the pension plan being shared 50-50 between the City and the employee.

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Not all elements of pension cost properly included in employee share

It also appears that not all the elements of the current pension plan are even included in the computation of the 50-50 sharing. As an example, the disability benefit, the DROP benefit, the 13th check, and the supplemental COLA do not appear to be included in the 50-50 sharing.

Actuarial assumption changes not made timely – thereby delaying employee rate increases.

Another concern is the lack of timeliness in addressing actuarial assumption changes. The cost of such a change going forward is supposed to be shared 50-50, but the cost of the past service liability created by that assumption change is paid 100% by the City. Thus any delay in recognizing assumption changes moves cost from a 50-50 share to 100% - 0%, City pays all.

Employee Rate Computation

It appears when changes are made to employee rates they are made on an average basis for ease of administration rather than on a specifically calculated adjustment for each age related group. It appears that this approach leads to a higher cost to people hired in at a young age and a subsidized cost for employees hired in at an older age.

Recommendation #14:

The PRC was not able in the time available to get a full explanation of the 50-50 City-employee sharing and the Pension costs. Therefore, the City, as Plan Sponsor, should request a full accounting from SDCERS by 12/31/04 as to:

A. *Why are not all cost elements of the Pension Plan included in the 50-50 City-employee cost sharing computation?*

B. *Were the costs of all benefit increases properly and timely reflected in the employee's rates?*

C. *Were the costs of all actuarial assumption changes properly and timely reflected in the employee's rates?*

D. *What action, if any, regarding City and employer contribution rates would be appropriate given the results of the above full accounting?*

(A response to the above is apparently in development by SDCERS staff in response to a Trustee's request.)

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Recommendation #15:

City should request SDCERS to establish by 12/31/04 a formal policy for establishing employer and employee contribution rates, including regularly scheduled reviews and assessments of actuarial experience trends and actuarial assumptions. (This is in development by SDCERS Staff.)

B. DISABILITY PENSION

High cost driver

One of the high cost drivers of the total cost of San Diego's Pension Plan is the disability provision. Disability accounts for close to 15% of the Total Normal Cost of the Pension. Worse, at present (as described above) the City is paying 100% of this cost with the employee **not** sharing 50-50.

At present, an incredible 23% of all City retirees are drawing a disability pension. When just focusing on Safety Members, 36% of all Safety retirees are on disability. Over 1/3 are disabled!

Lenient criteria for disabilities

It would appear this shocking large percentage of retirees on disability is due to the relatively lenient definition of "disability" used in the Pension Plan. An employee only has to demonstrate he/she is unable to perform their job. This is true even if the individual incurred this disabling injury on their personal time away from work.

A more demanding criteria for obtaining a disability pension is used by the Social Security System. Here a person must be unable to do any work in order to qualify. If an employee is injured on the job, the workers compensation system is designed to pay not only his medical bills, but if he/she is permanently disabled or permanently partially disabled, there is a payment made to cover the individual's diminution of earning power. Additionally, payments are made for retraining in other types of employment. The Social Security disability, becomes operative only if the individual is unable to be employed any where.

Financial incentive to claim disability

Currently when a City employee is injured on the job and is deemed unable to perform his job any longer, that individual will receive worker's compensation **and** a disability pension **and** be able, physical condition permitting, to go secure employment elsewhere. Thus as a result of their work related injury/disability they can easily wind up making far more money than what they made as a City employee. The basic rationale for a disability plan is to project the employee with an economic safety net in the event he can't work any longer – not to create the potential for a wind fall.

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In years past, the City Muni Code provided protection against "double dipping" from both workers compensation and disability simultaneously. Also there were protections which reduced disability payments for other income earned. Apparently these provisions were negotiated away to the Unions in meet and confer.

A further incentive to claim disability comes from SDCERS' chosen way of implementing the Muni Code. The issue here is the fact that a disability pension is, by IRS Code, 50% tax free income whereas a normal service pension is fully taxable.

Thus when an individual is eligible for a service pension (which is usually of greater dollars than a disability pension), if that individual can perfect a disability claim, SDCERS pays the person first the disability pension (50% of which is tax free) and then "tops it off" to get up to the full value of the service pension (that "top off" being fully taxable). Thus there is a tax savings incentive to claim disability. While this does not directly cost the City any more for that individual's pension (just the IRS "loses"), the City does incur significant administrative expenses to investigate and adjudicate the disability claim. Worse, these financial incentives can create an unwarranted culture in the workforce to seek disability retirements. The very large percentage of City retirees on disability already might suggest this is a problem.

Potential conflict of interest in the administration of disability pension

One of the many appearances (if not realities) of a conflict of interest on the Board is when Board members who are elected union officials have to sit in judgment on a union member's application for disability approval.

On questionable disability applications the Board sends them to an independent Hearing Officer who, after a formal legal style proceeding, returns a "recommendation" to the Board. The Board then must approve or override that recommendation.

The Board has no legal or medical expertise and, worse, the Board attempts to sit as an "appeals court" hearing pleas from applicants and their lawyers without any semblance of legal due process, including such basics as testimony under oath, the impermissibility of new evidence, etc.

SDCERS not currently complying with Muni Code regarding monitoring of disability pension.

Muni Code Section 24.0407 **requires** SDCERS to seek an annual affidavit from disability pensioners affirming they are still disabled. Section 24.0408, requires SDCERS to have disability pensioners submit to periodic physical exams to independently confirm their disability. SDCERS is not currently doing either of these requirements.

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***Recommendation #16*: (identical to PRC's recommendation)**

To eliminate the appearances of a conflict of interest in the administration of disability pensions and to institutionalize a rigorous, independent, judicial based process with proper medical expertise and legal due process, SDCERS should change their current practices when sending questionable disability applications out to an independent administrative law hearing officer. Instead of the Hearing Officer's conclusion being a "recommendation", it should be a "final decision" on behalf of the Board; such a decision, as with the current process, would still be appealable to Superior Court by either the applicant or the Board. This recommendation will remove the Board from making disability decisions when it does not have the expertise nor a reasonably equitable process to do such.

The PRC had submitted a proposed City Charter amendment to effect this recommendation. However City Council, on a 4 yes, 2 nay vote to approve, failed to carry this motion for a ballot proposition. Consequently I now strongly urge the City to recommend that the SDCERS Board to adopt this practice.

Recommendation #17:

Establish an economic ceiling on a disability pensioner's aggregate receipt from worker's compensation, disability pension and income from other employment. That ceiling should not exceed the ***current*** *rate of pay for the position the individual had held at the time of his disability. SDCERS to establish a process to administer this ceiling and reduce disability payments where the ceiling is breached.*

Eliminate the practice of paying a disability pension topped off to equal the service pension solely to afford tax free income to the retiree.

Recommendation #18:

SDCERS to perform their obligation under Muni Code 24.0407 and 08 regarding monitoring of disability pensioners, including periodic physicals to confirm continued disability. If a person drawing a disability pension is no longer deemed disabled their disability pension will cease assuming the City is willing to reinstate them as an employee. The City is to be encouraged to return the rehabilitated individual to City employment as a moral if not legal commitment to their employees and as a means of controlling total employment costs.

Recommendation #19:

If a new Pension Plan is to be created for new hires, replace the current criteria for disability with the Social Security system criteria.

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C. "EXCESS EARNINGS" AND THE "WATERFALL DISTRIBUTION"

The City has directed SDCERS to make certain payments out of trust assets based on the concept of "excess earnings". When the Trust's annual "realized" investment earnings (cash earnings from dividends, interest, or gains on actual sale of a security) reach a certain threshold then earnings in excess of that amount are deemed available for payment of certain prescribed benefits. The priority of those payments is referred to as the "waterfall".

Excess earnings are distributed according to the following "waterfall" dollar priority:

1st 8% (Actuarial earnings assumption) multiplied by the employer contribution reserve is credited to that reserve.

2nd 8% multiplied by the employee contribution reserve is credited to that reserve

3rd Annual SDCERS administrative budget is deducted

4th Retiree Health reserve (for amount of actual retiree health expense that year)

5th 13th check to retirees

6th Corbet payments to retirees

7th Supplemental COLA reserve

8th Employee Contribution Rate reserve

(There is also a deduction made and contributed to the Port and Airport employer reserves to compensate for the fact their members do not participate in the City's contingent benefits, to the 5th, 6th, 7th and 8th priorities.)

If there are insufficient excess earnings to satisfy all priorities, the lower priorities get nothing that year. Corbet is the only item which, not being paid in any given year, rolls forward on a cumulative basis to the next year, but without interest.

If there is more than enough "excess earnings," the remaining amount gets credited to the Employer Contribution Reserve, unless SDCERS, in the Board's sole judgment, creates some other "reserve."

In the last two years, for the first time ever, there were no investment "excess earnings" and therefore retirees did not receive any 13th check or Corbet payments.

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As stated earlier, this "excess earnings" concept is conceptually flawed. There is no such thing as excess earnings. The pension trust fund needs to earn 8% per year on average. Some years will be better, some years will be less. To dissipate the "excess earnings" from the good years obviously leaves nothing to cover the shortfall in the bad years.

The City has purposefully chosen to use this accounting slight of hand to pay for employee benefits, not from the City's annual operating budget as they should be, but rather by siphoning off assets from the trust fund in "good" years. However, there is no free money. This siphoning off creates actuarial losses which contribute to the unfunded liability. As stated earlier, this was one of the major contributors to the current $1.16 Billion deficit in the Pension Fund.

It is important to note that not only is the concept of earnings "excess" flawed, but also the measurement is inappropriate. First, the excess earnings computation works with "realized" (i.e. cash) earnings, not total earnings despite the fact the entire actuarial model works on "total earnings" (both realized and unrealized – i.e. "paper" gains not yet liquidated). Secondly, the excess earnings computation only accounts for an 8% earnings increment on the employer and employee reserves before deeming all else "excess" and available for other uses. This is a serious conceptual flaw. It neglects incrementing the present value of the retiree liability by the actuarially necessary 8%. For example, a preliminary estimate of "excess earnings" for FY '04 is as follows:

Estimate realized earnings for FY '04	$247.7 million
8% of Employer and Employee contribution reserves	- 77.1 million
"Available" excess earnings	$170.6 million

In reality, even if you want to measure excess earnings on a year by year stand alone basis, one should first deduct 8% times the **total** actuarial liability to reflect the proper actuarially computed growth in plan liabilities. Using FY '03 actuarial report values for illustrative purposes, the correct computation would be:

Estimate realized earnings for FY '04	$247.7 million
8% of total actuarial liabilities of $3.5 Billion	-280.0 million
"Available" excess earnings (loss)	(-$ 32.3 million)

In this example which is a close approximation to what the numbers will actually be for FY '04, if you are going to use "realized" earnings rather than "total earnings, then instead of having $170 million to "spend", there is actually a deficit of $32.3 million.

This "excess earnings" and "waterfall" aspect of SDCERS is one of the more glaring examples of the complexity and confusion of the Pension Plan. Not only is the overall concept flawed, but its use can lead to unintended consequences. For example, if SDCERS was to decide, for prudence sake, to lower the actuarial earnings assumption and therefore to increase the City's contribution rate, this move would, unintendedly, make the payment of the contingency benefits

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easier (i.e. less "excess earnings" now required to trigger payment of the contingent benefits), and thus more valuable to the retiree and more costly to the City.

Recommendation #20:

The conceptually flawed concept of "Excess Earnings" and the "Waterfall Distribution" must be corrected. Nothing should be paid from excess earnings. All contingent payments should be included in the actuarial calculation. The earlier recommendation (#3) calling for full inclusion of this contingent benefits will get them properly accounted for costing purposes for the City.

However, it must be remembered that there are several retiree benefits whose payments are contingent in nature and the contingency is determined by this accounting concept, flawed or not. The City has two choices, One, the current computational test, as conceptually flawed as it is, can, if desired, continue to function as the contingency test. To change the test would change the degree of contingency and therefore would be an improvement in value to the retiree.

Alternatively, the City could choose to greatly simplify the current plan's complexities involving this "excess earnings" concept and the "waterfall" by choosing to eliminate the contingency associated with these benefits and make them fixed. This would amount to a benefit increase, in that the annual payment of the 13th check would now be guaranteed and the payment of Corbet would likewise be guaranteed rather then deferred in some years.

Given the current significant cost problems the City already faces with its pension plan, the notion of increasing benefits (i.e. removal of the contingency) and thereby incurring cost is highly questionable. Nonetheless it is recommended that this alternative be analyzed to determine its cost impact (e.g. with the cost of these benefits more properly reflected in the 50-50 City – Employee split given they would then be accounted for as "normal pension," versus currently being accounted for as an actuarial loss which is 100% for the account of the City.) Further such a benefit "increase" might serve as part of a negotiation to secure agreement on the recommended elimination of the employee "pick-up" (see recommendation #5.

Removing the Retiree Health benefit funding from this excess earnings concept has already been recommended. However, since retiree health is a higher priority than the other contingent benefit, if the contingency nature of benefit is to be maintained, the removal of health care benefits from the "Waterfall" inappropriately enhances the probability of and therefore the value of the Contingent benefits. Therefore an appropriate proforma adjustment will need be made to the Waterfall each year.

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EMPLOYEE CONTRIBUTION RATE RESERVE

The last item on the Waterfall is the Employee Contribution Rate Reserve. This is another clever accounting maneuver designed by the City to not pay current year's cost out of the current year's budget, but rather to push those costs out to future years.

A few years back, the City in decided to "pick up" even more of the employee's 50% share of the pension cost. However instead of paying this bill currently, they use "excess earnings" to pay for such. The problem with this use of excess earnings has been well addressed above. The overall issue of the City's pick up is also addressed above.

> ***Recommendation #21:***
>
> *The City should immediately stop using excess earnings to pay for the "pick-up" of employee's contribution. If the City desires, or is obligated by Meet and Confer, to "pick-up" this amount of employee contribution, the City should make such payments out of the annual City budget.*

D. ROLE OF RETIREMENT BENEFITS IN CITY'S TOTAL COMPENSATION PACKAGE

During the PRC's deliberations, it was often heard that the reason the City's pension benefits were so "rich" was that such was necessary to offset less than competitive salary structure in a total employee compensation package.

The PRC was not able to obtain data nor pass judgment on whether the City's salary structure was in fact "below market" Or not.

However there are obvious pitfalls of using pension benefits to offset salary inadequacies. City pension benefits, once offered, are fixed and cannot, by law, be adjusted downward or eliminated if future economic conditions would so necessitate. Conversely, salary structures are not prevented by law to be adjusted to prevailing economic conditions.

The salary component of the compensation package must be paid currently, while the cost of pension benefit increases, particularly the past service liability portion, can be deceptively spread well out into the future. Thus it is an often used tactic by government officials to trade higher pension benefits for lower salary increases as a way of deferring the economic pain to the budget. This tactic is one of several which created the City's current pension and retiree health care deficits.

This tactic can often back fire, as follows: Once the pension benefits (which are formula driven based on salary) are increased in lieu of salary increase, then there is a "catch up" wage increase and the employee gets a compounding of both increases.

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Recommendation #22:

The City should not use extra pension or retiree health benefits to compensate for less than competitive salary structures. If employee turnover rates or hiring difficulties substantiate the allegation of a less than competitive wage packages, the City should adjust the wage package and pay for it currently out of the annual City budget. Do not purposely trade off salary increases for pension improvements, the cost of which is pushed out onto future year's taxpayers.

E. DESIRED PENSION TRUST FUNDED RATIO

The PRC discussed at some length what should be the goal for the funded ratio of the Pension Trust (and for the new Retiree Health trust once created as is recommended above). The issue reduces to one of i) fiscal prudence – i.e. 100% or greater funding, versus ii) pragmatic realities of employer – union negotiations wherein historically when funding approaches 100%, and certainly if it exceeds 100%, there is significant union pressure to increase benefits for the employees.

The PRC did not reach a consensus recommendation on this important issue. However, I believe the City should be well cognizant of this debate and recognize that any "goal" of less than 100% funding, while maybe "helpful" in union negotiations, clearly pushes current year City costs out into future year's City budgets and future years' taxpayers. This, I submit, is highly inappropriate fiscal management.

Recommendation #23:

The City, as plan sponsor, instructs SDCERS to set actuarial funding requirements to achieve a target of 100% funding.

F. DROP

The DROP benefit is a very controversial program. It is often referred to as the "double dip." This is what appears to generate the adverse publicity in that an employee can draw his/her salary **and** a pension payment **simultaneously**.

Union officials put forth an analysis (which they did to the PRC) which shows the DROP program, notwithstanding this "double dip," actually saves the City money. (The best defense is a good offense!) The argument is that since the "DROP'ed" employee is already receiving his/her pension there is no further pension expense computed for this pension (save for the City's extra payment to the employee's DROP account) and thus by keeping this DROP'ed employee on the payroll the City avoids having to pay a full pension expense accrual for a new employee if the DROP'ed employee had truly retired.

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The analysis appears mathematically correct but it is totally predicated on the extremely generous early retirement age. Since the employee doesn't have to work until 62 to get a full pension, they can DROP at 55, get their pension immediately and continue to work and earn their salary for another five years.

Change the retirement age to a more appropriate age – i.e. 62, and you eliminate most, if not all of the motivation for this double dip program.

Recommendation #8 calls for DROP to be completely eliminated for all new employees. For existing employees (for whom it would appear DROP can not be eliminated) there is an administrative change that needs be made

Currently SDCERS is choosing to credit DROP accounts with interest at the actuarial assumed earnings assumption of 8%. This is a controversial practice within SDCERS itself. The actuarial earnings assumption is, of necessity, a "long term" investment assumption. DROP money is far more short term in nature. The DROP program itself is up to a maximum of 5 years. Participants have the choice to leave their funds invested after they cease working. For the last few years it has been a "no brainer" to choose to leave your money in SDCERS at an 8% risk free rate of return, "guaranteed" by the City.

When SDCERS' actual earnings fall short of this assured 8% then SDCERS loses money on these DROP accounts. Conversely, when SDCERS makes greater than 8%, it "makes money" on their DROP accounts (although if the investment markets were to routinely pay more than 8% one would assume the retired DROP participants would withdraw their money from the SDCERS "8% bank" and invest elsewhere). Thus SDCERS is stuck with an unbalanced proposition.

Recommendation #24:

DROP accounts: CERS should credit short to medium term (max 5 year) money market/short term note rates of interest to the DROP accounts and hedge these DROP funds with 5 year investments such that SDCERS is essentially taking no risk nor seeking any gain in their investment of DROP monies.

Recommendation #25:

The administrative rules of DROP should be changed such that upon retirement, a DROP participant must withdraw his/her DROP fund from SDCERS. Such withdrawal can be rolled into an individual IRA, but SDCERS would no longer be involved. There is no reason for SDCERS to be involved in managing this money.

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IX. GOVERNANCE

The City ostensibly has created an independent Board, separate from the City, to administer the pension plan and to manage the assets held in trust.. However the City Charter dictates the composition of the 13 member Board of Trustees, as follows:

- 3 Representatives from City management
- 2 Representatives elected by police and fire members
- 3 Representatives elected by General Members
- 1 Representative elected by retired members
- 4 Independent citizens nominated by the Mayor and appointed by City Council

Thus the question of an "independent" board is raised. Do you have true independence when:

1. The majority of the trustees are direct beneficiaries of the decisions made by the Board?
2. When some trustees are members of senior management of the City, particularly when the City management has purposely advocated under funding of the plan?
3. When some trustees are elected union officials, arguably beholding to their members who voted for them, who are direct beneficiaries of the decisions made by the Board?

This certainly raises a question of appearance if not the reality of a conflict of interest. Some have argued that there is no potential conflict of interest since benefit levels are set by the City and not by SDCERS's Board. While the latter is true, it must be recognized that there are many decisions which the Board makes which do have a direct impact on the value or cost of the benefit to employees, of which the majority of the trustees are direct beneficiaries. The fact that SDCERS acquiesced to the City's demands for under funding as a means to increase pension benefits inherent in Managers Proposals I and II are examples of the appearance if not the reality of conflict.

The Board's complete authority in setting of DROP interest rates, of establishing pricing for Purchase Service Credits, of establishing actuarial assumptions which affect City and employee contribution rates are compelling examples of potential conflicts. The entire issue of the 50-50 cost split between the City and the Employees (discussed above) raises questions of how well the Board administered this.

To cure this appearance if not reality of conflict of interest which could undermine the "independence" the SDCERS Board, the Board should be comprised of all independent and professionally qualified individuals with substantial education and experience in the relevant disciplines in pension management. The Board should be reduced in size from its current unwielding 13 members to seven to facilitate informed discussion and debate on the many issues brought before it.

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There should be more disclosure and visibility on the financial condition of SDCERS and more direct accountability of the responsible officers of the System. For example while SDCERS is purportedly an independent agency, at present the Chief Financial Officer of SDCERS is the City Auditor.

Recommendation #26: *(Identical to PRC's Recommendation)*

Change the City Charter (through a vote of the citizens) to have a SDCERS Board comprised of seven members, all to be "independent," with no City employee, no member of City management, no Union leaders or City retirees on the Board. The seven members would each have a college degree or relevant professional certification and 15 years experience in pension administration, pension actuarial practice, accounting or investment management. The positions would be appointed by the Mayor and approved by the City Council for a maximum of two consecutive four year terms. A proposed City Charter amendment was submitted by the PRC to the City prior to the writing of this report in order to meet the time requirement for inclusion in the year's ballot.

Recommendation #27:

Assign the responsibility of Chief Financial Officer of SDCERS to a member of the SDCERS management team. Currently the position is held by a member of the City Manager's management team.

Recommendation #28:

SDCERS, in conjunction with an outside financial audit firm, should develop a process of personal management accountability as to the accuracy of the financial statements, operating information and internal controls of SDCERS consistent with the new Sarbanes Oxley reporting requirements in the private sector.

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X. POLICY AND PROCESS CHANGES TO PREVENT REOCCURRENCE OF CURRENT PROBLEMS

A completely independent SDCERS Board is a key step to preclude a reoccurrence of this problem. Being independent of City Management and Union/Employee interest in having higher benefits but deferring the payment of such, an independent Board will force the City to pay its bills when due and thereby preclude the City from committing to benefit improvements it cannot afford.

A. PAST SERVICE ELIGIBILITY FOR NEW PENSION BENEFITS

Benefit improvements have been "retroactive"

The City has over time granted improvements in retiree benefits to its employees. Essentially all of these improvements were "retroactive" for existing employees (i.e. granted for years of employee's service prior to the benefit improvement) as well as prospective, to be earned over the employee's future years' of service. Thus, the day a new benefit is granted not only will future years' expenses be higher but there is also a "past service" liability created which must be paid off over some decided upon number of future years (the "past service liability amortization period").

Very costly to City

This past service liability, by City Charter, is paid 100% by the City and not shared 50-50 with the employee. Thus this "retroactivity" makes the new pension benefit very costly for the City. Worse this past service liability is not paid from the City budget currently. The cost for this pension benefit from employee service going back 20-30 years will be paid out of City budgets over the SDCERS unfunded liability amortization period – currently 18 years out into the future.

A ballooning expense for future years taxpayers

When successive pension improvements with past service applicability are made over the years, this creates a sizeable and growing, ballooning cost being pushed out onto future years' taxpayers. There is a concern that when new benefits are proposed for City Council approval there is not a full awareness of the overall cost of this proposal and how long it will take to "pay off" this new debt – i.e. the past service liability that is created.

Recommendation #29:

*Any new pension benefits should ideally be prospective only (i.e. no past service applicability). **If** a new benefit is going to be "retroactive" for current employees (i.e. for past service), then the resulting past service liability must be amortized over a time*

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period no greater than 5 years. The PRC proposed a City Charter amendment to effect this.

B. FULL DISCLOSURE AND DISCUSSION OF PROPOSED NEW BENEFITS

I believe that the Meet and Confer process, with its frequent 11th hour negotiations, does not assure adequate understanding by the City Council of all the fiscal impacts of new proposed benefit improvements. An independent, comprehensive presentation of the long term costs of all proposed benefit improvements must be made to the City Council before it approves such.

Recommendation #30:

*A complete actuarial cost projection for at least a 15 year period is to be prepared for each proposed new benefit improvement. The President of SDCERS is to make a comprehensive explanation of the cost of this new benefit (and any administrative nuances with such) to the City Council to assure a full understanding by the Council of all the ramifications of this new proposal **before** they vote to approve the benefit.*

C. CITY'S LACK OF LONG RANGE FINANCIAL PLANNING

The City apparently does not have a practice of routinely developing long range financial plans. If such a practice had existed, the growing inability to pay for promised retiree benefits would have become quite apparent long ago.

Recommendation #31:

The City should institute a formal long range finance planning process (5-10 years) to assure visibility of long term cost commitments such as post retirement benefits. This recommendation was also made by the Mayor's Blue Ribbon Committee on City Finances back in February 2002.

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